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ABSTRACT

Alternative college retirement programs and features of a desirable retirement program are discussed. The historical, social, and economic forces that prompt institutions to consider alternative programs are identified. The present position of college faculty in terms of retirement options is also addressed. Since its inception, the Teachers Insurance and Annuity Association (TIAA) has been the principal retirement or pension program for the nation's independent colleges and universities, as well as for many public institutions. Retirement options include the variable annuity, 403(b) tax-deferred annuities, and mutual fund custodial accounts. An important issue is the choices that are available in addition to the TIAA, the College Retirement Equities Fund and the various state retirement systems. Criteria that should be addressed in beginning an evaluation of alternative retirement programs include: determining responsibility for the evaluation; specifying intended purpose/objective of the evaluation; evaluating service and counseling requirements of the organization; determining how much flexibility and choice should be available to the participant; and evaluating company characteristics, investment choices, contract features, and distribution features. (SW)

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1984 Annual Meeting Presentation

Alternative Retirement Plans

by JOHN D. HOGAN

In preparing to address alternative retirement plans, I realized I would have to criticize TIAA-CREF because it is *the* college and university retirement system. However, I do so with great reluctance. We are all indebted to TIAA-CREF for its pioneering role in private pension development and its significant innovations over the years. As an investment officer, I compete with TIAA-CREF and sometimes negotiate joint ventures with them. Investment personnel at TIAA-CREF are professionals in every sense, and, in the direct placement investment field, they are unexcelled.

TIAA-CREF's problem is the same one experienced by every very large organization—how to keep a giant nimble. The intent of this presentation is to:

1. Review the forces—historical, social, economic—that have brought us to the point of inquiring seriously into alternative retirement systems;

2. Evaluate the present position of college and university faculty in terms of retirement options;

3. Identify the features of a desirable retirement program—i.e., the criteria for selection of a program; and

4. Summarize alternati e programs that can meet these criteria.

John D. Hogan is senior vice president—investments, American General Corporation. He is also director, The Variable Annuity Life Insurance Company. This article is based on an address presented at the 1984 NACUBO Annual Meeting in Chicago.

Forces for Change

Pension fund growth is one of the most dramatic developments in the private sector during this century. In 1980, a little more than 100 years after the formation of the first private pension plan in 1875 by American Express, nearly half of all nonfarm employees were covered by such plans. Contributions were $70 billion and assets $400 billion. As with many other social developments, private pension funds were heavily influenced by the Great Depression and the Second World War. The former revealed the vulnerability of private plans to downtrends in the economy and the latter provided the economic growth and administrative machinery—wage stabilization policies and Tax Code changes—that stimulated private pension plan resurgence. From 1950 to 1980 the proportion of wage and salary workers covered by private plans nearly doubled and annual contributions grew 35-fold. Social security retirement benefits, which replaced nearly 19 percent of pre-retirement earned income in 1950, were replacing 51 percent by 1980.

The rapid growth of private pension plans and the large amounts of funds accumulated led inevitably to abuses. The availability of retirement benefits to a retired worker depended on the fiduciary responsibility assumed by the plan sponsor. Benefits were frequently denied because of trivial technicalities in eligibility requirements or the failure of investment policy to generate the income to fund liabilities. In 1974, after a decade of congressional hearings, the Employee Retirement Income Security Act (ERISA) was passed, establishing new standards of reporting, funding, and fiduciary responsibility. With ERISA, private pension funds assumed their role as reliable major supplements to social security retirement benefits.

This background review would seem to imply that provision of retirement through private plans has come of age and ceased to be an issue. To the contrary, the decade since ERISA was passed has been one of ferment, especially regarding tax-privileged plans.

Volatility of Financial Markets. The volatility of financial markets and a failure of traditional inflation-hedging investments to perform as expected are major forces influencing pension plan development. Swings of several hundred basis points occurred in interest rates over periods as brief as one quarter in 1980 and 1981. Common stocks, the traditional inflation hedge, performed badly during inflation and recession alike. Three-month Treasury bill yields displayed wide swings during the last five years. Between the first and second quarters of 1980, average bill rates dropped 8.5 percentage

points, then soared 8.6 percentage points over the next two quarters. Effective annual rate of return over the five-year period was 9.5 percent, but in any given quarter returns were as high as 18.8 percent and as low as −4.9 percent.

Failure of Traditional Investment Vehicles. The unanticipated volatility in asset values and rates of return disturbed retirees and those accumulating funds for retirement. A $10,000 investment made in the second quarter of 1979 would have grown in the subsequent five years to more than $17,000, with substantial increases and decreases along the way. The same $10,000 investment in Aaa corporate bonds would have increased to $16,500 in the third quarter of 1981, fallen to $12,500 in the second quarter of 1983, and reached $14,162 in the first quarter of 1984, a 6.7 percent effective annual rate of return. The swings in value of 10-year U.S. Treasury bonds were similar to those for corporate bonds, but the effective annual rate of return was slightly higher, 7.4 percent.

Retirement program participants were understandably concerned with the state of their accumulations in pension funds. It should be noted that portfolio managers faced with such volatile markets had their share of concerns as well. In any five-year period such as we have discussed here, only 25 to 30 percent of equity portfolio managers achieve returns better than the S&P 500 composite index.

Innovations. Innovations in retirement investment programs were forced by unstable markets and the failure of investment vehicles—notably common stocks—to perform as expected. These innovations included the introduction of investment vehicles such as money market funds, balanced funds, high-yield bond funds, and unit investment trusts with free movement of accumulations among wrapped funds.

Sophistication of Participants. In the course of this period, participants in pension funds became "street-wise" about interest rates. To an increasing degree they were unwilling to settle for mediocre performance or for being "locked in" to an earlier investment choice. They wanted to be able to change freely.

College and University Retirement Programs

College and university retirement programs parallel the general development summarized above.

TIAA had its origin in an act of philanthropy. In 1905, industrialist Andrew Carnegie recognized the need for a pension fund for college and university faculty and established a charity for this purpose. Then, in 1918, a $1 million gift from the Carnegie Corporation led to the founding of Teachers Insurance and Annuity Association (TIAA), which was structured as a nonprofit life insurance company and granted certain immunities to many of the regulatory requirements imposed on commercial insurance firms.

Since its inception TIAA has been the principal retirement or pension program for the nation's independent colleges and universities, as well as for many public institutions. The concept of a defined-contribution retirement program was pioneered by TIAA, and much of today's pension regulation has been shaped by actions of TIAA-CREF.

The Variable Annuity. The College Retirement Equities Fund (CREF) was introduced in 1952 to enable participants to place a portion of their retirement accumulation funds in equity-based securities. This was the first "variable annuity" and served as the prototype for commercial firms such as The Variable Annuity Life Insurance Company (VALIC), which was among the first commercial firms to develop variable annuity programs. Since VALIC was regulated as a commercial insurer, the company was involved in much of the litigation and the state-level enabling legislation that defined the regulatory guidelines for variable annuity products. A landmark 1959 Supreme Court decision was rendered in *VALIC* v. *SEC*, resulting in the regulation of variable annuity contracts both as securities offerings subject to federal securities law and as insurance programs subject to the insurance laws and regulations of the various states. From these beginnings a bewildering number of tax-favored programs have emerged. Each plan will be briefly discussed below in an attempt to clarify the choices available.

403(b) Tax-Deferred Annuities. One of the more significant developments leading to the availability of alternative retirement programs for college and university employees was the introduction of section 403(b) tax-deferred annuity programs. For many years the Internal Revenue Code contained provisions that encouraged certain charitable, educational, and religious organizations to establish retirement savings plans for their employees. However, until 1958, when Congress passed P. L. 85-866, the regulatory guidelines for such programs were not clear. Congress passed P. L. 87-370 in 1966, which further stated that employees of public schools, colleges, and universities could take advantage of 403(b) tax-deferred annuity programs. At this point many commercial carriers began offering 403(b) annuities as supplemental retirement programs for both public and independent colleges and universitites.

Mutual Fund Custodial Accounts. Until the passage of ERISA, such tax-deferred retirement programs were expressly limited to "annuity plans" offered by insurance companies. Among many other changes, ERISA made provisions for using the mutual funds offered under custodial arrangements as investment vehicles for 403(b) plans. Such custodial arrangements are described in Section 403(b)(7) of the Internal Revenue Code.

Other Tax-Favored Programs. In recent years other tax-favored programs have become available to employees of colleges and universities. Many public educational institutions offer deferred compensation programs as provided under Section 457 of the Internal Revenue Code. These plans are similar in many respects to 403(b) plans, as both provide for tax-deferred contributions and tax-deferred earnings during the accumulation phase of the program. Distribution provisions in a 457 deferred-compensa-

tion plan are generally more restrictive than in a TSA plan, and under current rules contribution levels are limited to the lesser of 25 percent of salary or $7,500. Deferred-compensation plans for nonpublic employers are commonly known as "top hat" plans—such programs are available only to "highly paid" employees of the organization. These private deferred-compensation plans also have more restrictive distribution provisions than TSA plans.

Recently 401(k) deferred-compensation or cash programs have received considerable publicity. However, some questions remain as to the availability of such plans to employees of public institutions and 501(c)(3) organizations. The contribution limits and restrictions on distributions from 401(k) plans are similar to those applicable to 401 pension plans. Another area of concern with respect to 401(k) plans is the monitoring of special antidiscrimination rules.

In addition to the plans cited, employees of colleges and universities are, of course, eligible to participate in individual retirement accounts as provided under section 408 of the Internal Revenue Code. Such plans can be established on an individual or a group basis. When an employee's plan is amended to accept IRA contributions, the contributions are referred to as QVECs (qualified voluntary employee contributions). IRAs and QVECs are both subject to penalty if withdrawn before age 59½. Simplified employee pension plans (SEPs) may be less attractive to colleges and universities than other plans. SEPs are hybrids, with characteristics of both IRAs and 401 plans. They provide for deductible employer contributions, as in the case of 401 plans, and are subject to IRA-type distribution rules.

Evaluation of Present Position

At the present time TIAA-CREF serves over 90 percent of all independent colleges and universitites, as well as public institutions in at least 34 states. It is now recognized as the nation's largest nonfederal pension fund.

The rapid and unprecedented changes in the economic environment and TIAA-CREF's widely publicized reluctance to alter substantively the programs available to participa... have resulted in a growing desire for more flexibility and choice. Although to our knowledge fewer than 100 of the approximately 3,400 institutions utilizing TIAA-CREF as a principal retirement program have actually introduced alternative programs, a very significant number appear to be evaluating such programs.

A similar situation is clearly developing among public higher education institutions regarding alternatives to state retirement or state teacher retirement programs. The state of Texas has offered an Optional Retirement Program (ORP) since 1968 for employees of state higher education institutions. Under this program eligible employees may elect to participate in either the Texas Teacher Retirement System or the optional retirement program. It is interesting to note that, under Texas ORP, employees have a choice of commercial programs offered by more than 60 different insurance companies, and officials seem pleased with the overall operation of the plan.

A similar optional retirement program was introduced in summer 1984 for eligible employees in the State University System of Florida. Participants from the nine state universitites under this program can participate in the Florida Retirement System or in optional programs available through four commercial carriers. One of the principal benefits that ORPs were designed to achieve is enhancement of a university system's ability to attract quality faculty members by providing greater flexibility, more investment choices, and, typically, shorter vesting periods. Several other state retirement systems are now in the process of studying such alternative retirement programs.

The desire for "reasonable choice" is at least in part what is motivating this process. The issue of reasonable choice first surfaced in Labor Department regulations issued in 1979 and was subsequently addressed by the Employee Retirement Tax Act of 1981 (ERTA) and the Tax Equity Fiscal Responsibility Act of 1982 (TEFRA). These regulatory developments have helped to produce growing pressure from both faculty and administration for more options and greater flexibility in retirement programs.

Achievements to Date. In reviewing the present state of faculty retirement programs, one should be careful not to detract from what has been achieved. For the faculty member or administrator in early career at the present, replacement of pre-retirement income at retirement can be achieved through a combination of indexed social security retirement benefits, TIAA-CREF pension benefits, and alternative or supplemental tax—deferred annuities—the critical element in the mix. Regular contributions to such annuities from payroll deduction or lump-sum contributions from savings accumulate large sums relatively fast.

Power of Tax-Deferred Compounding. Those who can buy tax-deferred annuities enjoy substantial benefits not available to the general public, including tax-deferred compounding on savings contributions. Over a 20-year period an initial lump sum of $20,000 reaches $112,088 at 9 percent, $161,246 at 11 percent, and $230,461 at 13 percent.

Accumulation of regular contributions from salary deduction is as follows: a $200 per month contribution, assuming a 10 percent annual return, accumulates $40,292 in 10 years, $80,324 in 15 years, $144,791 in 20 years, and $415,559 in 40 years. Payout from $415,859 at age 65 on a 10-year annuity certain and life thereafter basis would be approximately $57,000 per annum. This contribution level is substantially below the maximum permitted by law. Contributing at maximum levels could permit young faculty members to accumulate retirement funds of more than $1 million, in which case the $57,000 per annum figure would become $137,000. Visions of such accumulations obviously could encourage many to make considerable sacrifices in current consumption for the sake of future rewards.

Selection of a Program

There is a substantial body of literature on the subject of state-of-the-art retirement alternatives for college and university faculty. Criteria on which the prevailing programs such as TIAA-CREF have been judged include: strength and commitment of the provider company, range of available investment choices, flexibility of contract provisions, and servicing capability.

The strengths and weaknesses of TIAA-CREF according to these criteria have been well documented and it is sufficient here merely to compare with TIAA-CREF some features of state-of-the-art plans. It is, of course, understood by retirement program professionals that TIAA-CREF is modifying long-standing practices to accommodate certain of the above criteria.

In general, the TIAA-CREF program offers fewer investment vehicle choices than state-of-the-art plans and much less flexible transfer among investment choices and payout provisions.

It should be emphasized that the issue here is additional choices, not elimination or replacement of programs available through either TIAA-CREF or the various state retirement systems. We are not aware of any situations where elimination or replacement has been seriously considered. Further, we fully support the position that any college or university considering alternative programs should cautiously and carefully evaluate such programs—a position that has often been expressed in various NACUBO committee reports and publications.

Evaluation of alternative retirement programs is a demanding, time-consuming effort. Several critical issues should be addressed at the beginning of the process.

1. *Responsibility for the Evaluation.* One of the first steps is to determine who will be responsible for the evaluation process. Typically, this function is performed by the personnel or benefits department of the institution, an ad hoc committee, an outside consultant, or some combination of these. Of course, the size of the organization and the scope of the review often help decide this issue. Another factor is the availability of current research by institutions having comparable retirement objectives.

2. *Intended Purpose/Objective of the Evaluation.* Many institutions have determined initially to offer alternatives only with respect to supplemental programs. Others favor offering additional choices or flexibility under their basic retirement program. A major factor to consider is that in all probability a substantially smaller portion of the institution's employees will benefit if the expansion of investment choices or flexibility is limited to a supplemental program.

3. *Service and Counseling Requirements.* Before determining the specific investment options or programs to be offered as alternatives, the service and counseling requirements of the organization should be carefully evaluated. Increased choices require more explanation, which may present a hardship for the institution's personnel or benefits administration staff. In addition, complex investment options may require consultation with professionals specifically trained in the field of investments or securities. Such factors may necessitate either an increase in the benefits administration staff or the selection of programs that are offered by organizations providing substantial counseling and ongoing service.

4. *Flexibility and Choice.* One of the most sensitive issues in the evaluation of retirement benefit plans is the determination of how much flexibility and choice should be available to the participant. One of the foremost concerns is that the program be designed to meet retirement needs, particularly in the case of the basic retirement plan. This concern is mainly directed at the distribution provisions of the plan and the availability of lump-sum options. In addition, the degree of transfer flexibility among investment choices should be determined prior to evaluation of specific programs.

5. *Evaluation of Specific Companies and Programs.* Major criteria in the evaluation of specific companies and programs include company characteristics, investment choices, contract features, and distribution provisions.

5a. *Company characteristics.* In evaluating a specific provider company, the basic areas of concern include the financial stability of the company, reputation in the retirement benefit program market, experience, level of commitment demonstrated over time, and service capabilities. Recent events in the annuity and financial services industries clearly indicate the need for careful evaluation of a company's ability to meet the needs of an ongoing retirement program. Many financial services companies that have a reputation for providing competitive programs seem to become less competitive as company priorities change. Programs must be selected that can meet the criterion of long-term commitment to serving participants.

The need for a company with additional service capability may vary according to the resources of the institution's personnel/benefits administration staff. However, as the number and complexity of the investment choices made available to the employee increase, the burden of explanation and counseling also increases. Prior to selecting a provider company, personnel/benefits administrators should conduct in-depth interviews with representatives of the provider company to assure that service capabilities are consistent with the requirements of the institution's retirement program.

5b. *Investment choices.* The economic environment and recent investment innovations have produced a wide range of alternatives for funding retirement benefit programs. The selection of an offering company should depend, among other factors, on an analysis of the availability of investment choices, current and historical performance information, and on transfer flexibility.

5c. *Contract features.* There can be significant differences in terms of contract features and provisions among insurance companies offering similar investment choices. Direct and contingent charges and expenses and limitations that may apply to transfers among invest-

ment choices must be carefully evaluated.

5d. *Distribution features.* Finally, the evaluation should include an analysis of the distribution or payout features of the program. The essential elements to review include the range of payout options available, any cost or penalties associated with annuitization, the level of flexibility provided by the offering company, and the competitiveness of annuitization factors (current and historical).

Conclusion

This presentation has sought to review the forces operating on college and university retirement systems, to evaluate retirement program options, and to identify the features of a desirable program.

In response to the economic ferment and the substantial volatility in financial markets of recent years, providers have developed a variety of alternative retirement program options for colleges and universities. To cope with the number and complexity of these programs, business officers—as important centers of influence on their campus—are in an excellent position to help shape the programs that will best meet the retirement needs of faculty and administration. ♦

business officer

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